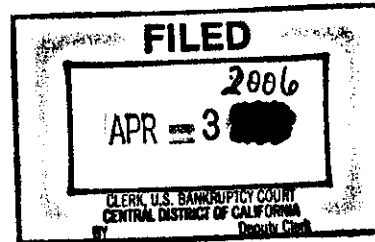


1 NOT FOR PUBLICATION



7
8 UNITED STATES BANKRUPTCY COURT
9 CENTRAL DISTRICT OF CALIFORNIA
10 SAN FERNANDO VALLEY DIVISION

11
12 In re

13 APPLAUSE LLC,

14 Debtor.

Case No. SV 04-15821 MT

Chapter 11

15 MEMORANDUM OF DECISION AND
16 ORDER ON DEBTOR'S MOTION FOR
17 RECONSIDERATION OF THE
18 MEMORANDUM OF DECISION AND
19 ORDER OVERRULING IN PART AND
20 SUSTAINING IN PART DEBTOR'S
21 OBJECTION TO CLAIM OF WEST COAST
22 LIQUIDATORS (CLAIM NO. 95)

Date: April 3, 2006

Time: 10:00 a.m.

Place: Courtroom 302

23 **Background**

24 This matter relates to two proofs of claim filed in this case: (1) Claim No. 56, filed
25 by AMB Institutional Alliance Fund, II (AMB) in the amount of \$1,317,054.52; and (2)
26 Claim No. 95, filed by West Coast Liquidators (WCL) in the amount of \$1,084,426.92.

1 Both of these proofs of claim were timely filed prior to the January 15, 2005 deadline.
2 AMB's claim was exclusively for unpaid future rents arising from breach of the lease.
3 WCL's claim was for repayment of its prior payments on a letter of credit it posted in
4 favor of AMB to cover Debtor's nonpayment, plus miscellaneous contractual damages.

5 WCL leased a warehouse to Debtor prepetition. Subsequently, WCL sold its
6 interest in the warehouse to AMB. As part of this transaction, WCL posted a letter of
7 credit in favor of AMB in the amount of \$950,000. Debtor defaulted on rent payments,
8 and AMB drew against the line of credit. The prepetition draw was \$415,738.89, the
9 postpetition, prerejection draw was \$114,950.67, and the postrejection draw was
10 \$304,389.77. The total draw was in the amount of \$950,000.

11 The Debtor objected to both proofs of claim. With respect to the AMB proof of
12 claim, the Debtor argued that AMB's claim should be reduced to the extent that it
13 received a portion of its damages by way of payment from the letter of credit.
14 Specifically, AMB's \$1.3 million future rents claim would need to be reduced because
15 AMB received \$419,310 in payments on the Debtor's future rents from the WCL letter
16 of credit. In addition, Debtor contended that AMB either had re-leased the premises or
17 should have done so under applicable California law. In its response, AMB agreed that
18 its claim should be reduced by the amount it received from the WCL letter of credit. It
19 concluded that its proof of claim should be reduced to \$941,058.46. Subsequently,
20 AMB and the Debtor stipulated to a proof of claim in the amount of \$800,000.

21 With respect to the WCL claim, the Debtor argued that the claim must be
22 disallowed in part and subordinated under 11 U.S.C. § 509(c). First, the claim cannot
23 exceed \$950,000, the amount WCL paid to AMB on the letter of credit. This is because
24 the claim is based on subordination, not on any contract. There is no contractual
25 privity. Second, because WCL's claim is subrogated, it could not receive any
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1 distribution until AMB is paid in full the amount of its claims against the Debtor's estate.
2 Third, the priority portion of WCL's claim would need to be reclassified as a general
3 unsecured claim. WCL, as a subrogee, stepped into the shoes of AMB and could only
4 sustain a priority claim that could have been asserted by AMB. However, AMB
5 expressly waived the right to assert administrative expense or priority gap period priority
6 claims on October 8, 2004 in the lease rejection stipulation. Moreover, any
7 postrejection payments under the lease are not administrative expenses of the estate.

8 WCL responded to the Debtor's objection by arguing that sustaining the
9 objections would result in a windfall to the Debtor. Since AMB was not asserting a
10 claim on behalf of WCL, if WCL were precluded from doing so on its own by section
11 509(c), then the Debtor would unfairly benefit. The debt remains due and owing and
12 cannot be avoided. WCL contended that if AMB waived its right to recover the amount
13 it received in draws, then the right to seek direct payment should vest with WCL. Thus,
14 the Court should determine that the \$950,000 in draws against the letter of credit are a
15 valid debt and that, to the extent that AMB does not seek recovery of these draws, WCL
16 should be entitled to a claim for the full amount of these draws.

18 Following the filing of the above moving papers, the Debtor and AMB signed a
19 stipulation that would reduce AMB's claim to \$800,000. In light of this fact, the Debtor
20 contended at the January 30, 2005 hearing that WCL could no longer assert a claim
21 against the state under section 509(c) since AMB has not been paid in full. In addition,
22 WCL holds only a general unsecured claim due to AMB's waivers in the lease rejection
23 stipulation. At most, WCL could only claim a \$800,000 general unsecured claim
24 against the estate at this point. WCL's dispute is really with AMB, not the Debtor.

25 WCL countered that its claim is really one for contribution or reimbursement, or,
26

1 in the alternative, subrogation. AMB has not asserted the claim that WCL is asserting,
2 and a claim should not simply vanish just because AMB failed to assert it. The claim
3 has not been disallowed, and someone must have the right to assert it. There is only
4 one recovery at issue; there is no double-recovery problem. The Debtor clearly
5 benefitted from the WCL's payments through the letter of credit. Thus, WCL should be
6 entitled assert a claim for \$950,000. Moreover, since WCL was not a party to the lease
7 rejection stipulation, this agreement does not bind WCL. As such, WCL should also be
8 able to assert a priority claim for postpetition rent payments.¹

9
10 This Court continued this hearing to a February 27, 2006 holding date in case,
11 after reviewing the pertinent law, the Court needed any additional factual information.
12 Concluding that no additional facts were necessary, the Court vacated the February 27,
13 2006 hearing and entered its ruling on February 23, 2006. Relying on the plain
14 language of *In re Chateagay Corp.*, 94 F.3d 772, 779-80 (2d Cir. 1996), the Court held,
15 inter alia, that because AMB and the Debtor settled the claim amount, AMB's claim
16 constituted "payment in full" under 11 U.S.C. § 509(c).

17 On March 3, 2006, Debtor filed a Motion Pursuant to Section 502(j) for
18 Reconsideration of the Court's order. Having read the motion and opposition thereto
19 and reviewed all of the relevant facts and law of this case, the Court finds that its prior
20 order was legally erroneous. Accordingly, the Court's prior order is hereby VACATED.
21

22
23
24 ¹ It should be noted that WCL's counsel was never served with the
25 proposed settlement agreement between the Debtor and AMB, notwithstanding
26 the fact that (1) WCL filed a request for special notice early in this case on
September 23, 2004, (2) the Order Establishing Notice and Service Procedures,
entered on November 25, 2004, required service on WCL's counsel, and (3) this
agreement could potentially have been prejudicial to WCL's rights.

1 **Discussion**

2 11 U.S.C. § 509 is not the exclusive source of subrogation rights in a bankruptcy
3 proceeding. See *In re Spiritos*, 103 B.R. 240, 244 (Bankr. C.D. Cal. 1989) Instead,
4 “[t]here are various types of subrogation, most commonly categorized as ‘conventional’
5 or ‘contractual’ subrogation, ‘legal’ or ‘equitable’ subrogation, and statutory
6 subrogation.” *In re Hamada*, 291 F.3d 645, 649 (9th Cir. 2002). Here, WCL could have
7 a claim by way of subrogation either (1) by contract, (2) by way of equitable principles,
8 or (3) by way of statute, such as 11 U.S.C. § 509. Under any and all of these legal
9 theories, WCL’s claim against the Debtor must be subordinated to AMB’s claim.
10

11 1. *Contractual Subrogation*

12 WCL holds a contractual right to subrogation by virtue of the language of the
13 First Amendment to Purchase Agreement between it and AMB. See Exh. C to Motion,
14 p. 207 (“[T]o the extent [AMB] receives any reimbursement pursuant to the Letter of
15 Credit, [WCL] will be subrogated to any rights that [AMB] may have against the tenant
16 under the Applause Lease to the extent of any such reimbursement made by [AMB] to
17 [WCL].”). This First Amendment to Purchase Agreement is “governed by, construed
18 and enforced in accordance with, the laws of the State of California.” *Id.*

19 Under California law it is settled that the “made whole” rule applies to claims that
20 arise by way of contractual subrogation as well as claims for reimbursement. See
21 *Progressive West Ins. Co. v. Yolo County Superior Court*, 135 Cal.App.4th 263, 274
22 (Cal. App. 2005). “It is a general equitable principle of insurance law that, *absent an*
23 *agreement to the contrary*, an insurance company may not enforce a right to
24 subrogation until the insured has been fully compensated for [his or] her injuries, that is,
25 has been made whole.” *Id.* (citation omitted). A “contractual provision that intends to
26

1 vitiate this rule must 'clearly and specifically [give] the insurer a priority out of proceeds
2 from the tortfeasor regardless whether the insured was first made whole.'" *Id*
3 *Progressive* considered whether the following policy language vitiated the "made whole
4 rule": (1) *Progressive* "is entitled to all the rights of recovery that the insured person to
5 whom payment was made has against another"; and (2) "When an insured person has
6 been paid by us under this policy and also recovers from another person, entity, or
7 organization, the amount recovered will be held by the insured person in trust for
8 [Progressive] and reimbursed to [Progressive] to the extent of our payment." The court
9 held that because these provisions do not clearly indicate that *Progressive's* rights are
10 first in priority, do not explain that *Progressive* may seek reimbursement regardless of
11 whether the insured was made whole by his recovery from a third party, and/or do not
12 assign or transfer all rights to the insurer to the extent of the insurance company's
13 payment, the made-whole rule was not vitiated by this policy language.

15 The policy language in *Progressive* is analogous to the subrogation language in
16 the First Amendment. First, the language does not clearly indicate that WCL's rights
17 are first in priority over AMB's rights. Second, the language does not explain that WCL
18 may seek reimbursement regardless of whether AMB was made whole. Third and
19 finally, the language does not specifically assign or transfer any rights. Because, under
20 the above law, the "made whole" rule is not vitiated, and because, as I conclude below,
21 AMB was not made whole, WCL holds at most a \$950,000 contingent claim by way of
22 contractual subrogation. Because WCL's contractual subrogation claim would not be
23 enforceable until AMB is paid in full, and because AMB will not be paid in full, WCL's
24 claim is in effect subordinated and of no value.
25
26

1 2. *Equitable Subrogation*

2 Under California law, a party will only have the right to equitable subrogation if
3 five elements are met: "First, the claimant must have paid the debt owed to the
4 lienholder in order to protect the claimant's own interest. Second, the claimant must not
5 have acted as a volunteer. Third, the claimant could not have been primarily liable for
6 the debt he paid. Fourth, the claimant must have paid the entire debt owed to the
7 lienholder. And, fifth, the subrogation must not work an injustice to the rights of others."
8 *In re Hamada*, 291 F.3d 645, 651 (9th Cir. 2002).

9 Applying these elements to this case, WCL does not hold a right to equitable
10 subrogation because, as will be demonstrated below, the debt to AMB has not been
11 paid in full. Thus, any claim for equitable subrogation must be disallowed.

12 3. *Statutory Subrogation under 11 U.S.C. § 509*

13 WCL is subrogated to the rights of AMB to recover unpaid rent from the Debtor
14 under 11 U.S.C. § 509(a) ("Except as provided in subsection (b) or (c) of this section,
15 any entity that is liable with the debtor on, or that has secured, a claim of a creditor
16 against the debtor, and that pays such claim, is subrogated to the rights of such creditor
17 to the extent of such payment."). "[T]here is nothing about the basic structure of the
18 letter of credit transaction that calls for treatment different than other co-obligors in
19 bankruptcy."² *In re Condor Systems, Inc.*, 296 B.R. 5, 16 (9th Cir. B.A.P. 2003). "As
20 with other forms of guarantee, payment by the issuer gives rise to a right of
21

22 ²
23 Although California recognizes that applicants and issuers of letters of
24 credit are subrogated to the rights of the beneficiary of the letter of credit, see
25 Cal. Comm. Code § 5117(a) and (b), this "section does not grant any right of
26 subrogation. It grants only the right that would exist if the person seeking
subrogation 'were a secondary obligor.'" U.C.C. Comment 1 to Cal. Comm. Code
§ 5117. Thus, the right to subrogation must be derived from another source.

1 reimbursement and subrogates the issuer to the rights of the beneficiary.” *Id.* at 17.

2 Although WCL asserts that its claim is for contribution or reimbursement, rather
3 than subrogation, this distinction is immaterial here, since section 509(c) provides that
4 in either case WCL’s claim would be subordinated until AMB is “paid in full.” 11 U.S.C.
5 § 509(c) provides that “[t]he court shall subordinate to the claim of a creditor and for the
6 benefit of such creditor an allowed claim, by way of subrogation under this section, or
7 for reimbursement or contribution, of an entity that is liable with the debtor on, or that
8 has secured, such creditor’s claim, *until such creditor’s claim is paid in full*, either
9 through payments under this title or otherwise.” Based on this language, the Debtor
10 contends that WCL is not entitled to any payment because AMB has not been and will
11 not be paid in full because the estate has insufficient funds to make a large distribution
12 on unsecured claims. Unsecured creditors are projected to only receive 12-15%.

14 A. *Manifest Error of Law*

15 In this Court’s prior order, I came to the conclusion that Section 509(c) did not
16 apply to WCL because AMB had been paid in full by virtue of its settlement with the
17 Debtor. In coming to this conclusion, the Court relied primarily on the language of *In re*
18 *Chateagay Corp.*, 94 F.3d 772, 779-80 (2d Cir. 1996) dealing with the question of
19 whether “payment in full” has been made under Section 509(c) when the primary
20 creditor settles with the debtor. Specifically, *Chateagay* stated that “acceptance of the
21 settlement . . . constitute[s] the requisite ‘full payment’ of the DOL claims within the
22 meaning of § 509(c).” *Id.* at 80. Although nothing in the *Chateagay* opinion itself
23 causes the Court to change its opinion on this issue, particularly since it never disclosed
24 the details of the settlement agreement in that case, further research and information
25 has led me to conclude that AMB has not been and will not be paid in full. Accordingly,
26

1 Section 509(c) applies and WCL's claim should be subordinated.

2 Notwithstanding the language of *Chateagay*, this Court concludes that settlement
3 between a primary obligor and a debtor in itself does not cause a claim to be paid in full
4 or deemed as such. If mere settlement caused a claim to be paid in full, then Section
5 509(c) would not apply if AMB and the Debtor settled their dispute down to \$800,000,
6 but Section 509(c) would apply if AMB voluntarily reduced its claim to \$800,000 on its
7 own accord. This simply does not make sense. Instead, *Chateagay* must mean that a
8 claim is paid in full if there is a settlement between a primary obligor and a debtor *and*
9 *that the amount of the settlement is, in fact, paid*. To the extent that *Chateagay* holds
10 otherwise, this Court declines to follow it. The fact that AMB has not been and will not
11 be paid the full \$800,000 because the estate has insufficient funds to pay unsecured
12 creditors in full is the distinguishing factor. Because AMB has not been and will not be
13 paid in full, Section 509(c) must apply, and WCL's claim must be subordinated.

14
15 B. *Policy Justifications*

16 This result is based on sound and well-established policy principles. The
17 language in Section 509(c) derives from the common law "made whole" rule, discussed
18 in more detail above. In *Restatement (Third) of Surety and Guaranty*, § 27(1), the rule
19 is described as follows: "Upon total satisfaction of the underlying obligation, the
20 secondary obligor is subrogated to all rights of the obligee with respect to the underlying
21 obligation to the extent that performance of the secondary obligation contributed to that
22 satisfaction." *Comment b* explains the general policy behind this rule:

23
24 The purpose of subrogation is to reallocate the cost of performance from the
25 secondary obligor to the principal obligor. The mechanism by which this
26 reallocation is accomplished should not cause any disadvantage to the obligee.
The obligee would be disadvantaged, however, if the secondary obligor were
subrogated to rights of the obligee before complete satisfaction of the underlying

1 obligation. In such a case, the rights obtained pursuant to the underlying
2 obligation, with the result that the remaining rights of the obligee on account of
3 the underlying obligation could be diminished. Moreover, because both the
4 secondary obligor and the obligee would be asserting rights arising from the
5 same undivided claim, conflicting enforcements could easily result. Thus, the
6 secondary obligor is not entitled to subrogation to the right of the obligee until the
7 underlying obligation is completely discharged.

8 In *American Surety Co. v. Sampsell*, 327 U.S. 269, 273-74 (1946), the Supreme Court
9 discussed similar policy concerns in the insolvency context:

10 The bond was intended to protect materialmen and laborers who worked on the
11 job so that they would not have to bear the risk of Stratton's insolvency. But for
12 his insolvency and bankruptcy these laborers and materialmen would have been
13 able to recover from him the money due them, no matter what their rights against
14 the surety might have been. Consequently the surety should not by claiming
15 under subrogation or indemnity for money paid to some of the creditors for
16 whose benefit the bond was intended, be allowed to reduce the share of the
17 bankrupt's assets due to other creditors whom the bond also was intended to
18 protect from insolvency. For this would tend to defeat the very purpose for which
19 the bond was given and therefore cannot be permitted under the equitable
20 principles governing distribution of a bankrupt's assets.

21 By analogy to this case, the Court could find that the letter of credit was intended
22 to protect AMB, Debtor's landlord, so that AMB would not have to bear the risk of the
23 Debtor's bankruptcy. But for Debtor's insolvency and bankruptcy, AMB would have
24 been paid for the rents due, no matter what its rights against WCL might have been.
25 Consequently, WCL should not, by claiming under subrogation or indemnity for rents
26 paid from the letter of credit, be allowed to reduce the share of the Debtor's assets due
to AMB, for whom the letter of credit was intended to protect from insolvency. This
would tend to defeat the very purpose for which the letter of credit was given and
therefore cannot be permitted under the equitable or statutory principles governing
distribution of the Debtor's assets in this case. Put simply, AMB bargained for the letter
of credit to protect itself from the credit risk the Debtor posed. WCL, making a business
decision to close the sale and get the job done, agreed. It makes sense from a policy

1 standpoint that now WCL should not be permitted to dilute AMB's recovery. It
2 voluntarily assumed the risk that the letter of credit would be drawn upon.

3 C. *Other Considerations*

4 Having said all of this, I have reservations with respect to the result, which derive
5 from the fact that AMB did not seek to recover any money on behalf of WCL. To the
6 extent that AMB had the right to assert a full claim (as opposed to its net damages),³
7 this is unfortunate and leaves matters between AMB and WCL unresolved. As the First
8 Amendment to Purchase Agreement specifically provides that AMB must reimburse
9 WCL to the extent it is reimbursed, See Exh. C to Motion, p. 206, there appears to be
10 no reason why AMB should not have asserted its full claim against Debtor to the extent
11 it was able to do so. Now, to the extent that WCL has a remedy, it will be against AMB.
12

13 D. *Amount and Characterization of Claim*

14 In sum, this Court finds that WCL is entitled to a \$950,000 subordinated claim.
15 WCL is specifically not limited to asserting a \$800,000 claim. For one, the claim that
16 AMB is asserting is not identical to and does not overlap with the WCL claim. Thus,
17 WCL should not be specifically limited to the amount claimed by AMB. Moreover, AMB
18 did not have the power to modify the characterization or amount of the WCL claim
19 retroactively. WCL's rights vested and could no longer be modified the moment it
20 acquired them by virtue of payment through the letter of credit. "Although parties may
21

22 ³

23 The Debtor has taken inconsistent positions on this issue. In its objection
24 to AMB's claim, it asserted that the claim should be reduced to AMB's net
25 damages. Now in the Motion for Reconsideration, it asserts that WCL could
26 have and should have filed a proof of claim in AMB's name to recover damages
for AMB and itself under 11 U.S.C. § 501(b). However, Section 501(b) provides
WCL little solace since that provision specifically applies *only* if AMB does not
file a proof of claim. In this case, it did.

1 by agreement grant greater subrogation rights than would have been ordinarily
2 recognized in equity, a surety can acquire, by way of equitable subrogation, no greater
3 rights than were possessed by the creditor *at the time of the payment which effected*
4 *the subrogation.*" C.J.S., Subrogation, § 66 (citing *Alexander v. Young*, 65 F.2d 752,
5 757 (10th Cir. 1933 (citing numerous cases))) (emphasis added); see also *Globe &*
6 *Rutgers Fire Ins. Co. v. Hines*, 273 F. 774, 777 (2d Cir. 1921) ("The principle is a
7 general one in the law of subrogation that a surety, paying off a debt, can acquire no
8 greater rights than the creditor had *at the time of payment*, as the surety cannot be
9 placed in a more favorable condition than the principal.").

11 It is unnecessary for me to reach the question of whether any part of WCL's
12 claim is a priority claim under 11 U.S.C. § 507(a)(1). Even if a part of it qualified as a
13 priority claim, it would still be subordinated under Section 509(c).

14 **Conclusion**

15 In conclusion, the Motion for Reconsideration is hereby GRANTED and the
16 Court's prior order is VACATED. All objections are OVERRULED. The Debtor's
17 objection to Claim 95 is sustained. Claim 95 is hereby reduced to \$950,000 and shall
18 be subordinated to AMB's claim until AMB's claim is paid in full.

20 **IT IS SO ORDERED.**

24 DATED: April 3, 2006

23 
25 MAUREEN A. TIGHE
United States Bankruptcy Judge

CERTIFICATE OF SERVICE BY MAIL

I certify that a true copy of this **ORDER** was served on APR 3 2006
to the parties listed below:

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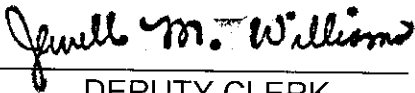
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DEPUTY CLERK